



THE
LAW SOCIETY
OF HONG KONG
香港律師會

**Consultation Paper on the Securities and Futures
(OTC Derivative Transactions – Reporting and
Record Keeping) Rules**

The Law Society's Submissions

Q1. Do you have any comments or concerns about the proposed definition of “Hong Kong person”, “RCH” and “ATS-CCP”?

Law Society's Response:

In the definition of “Hong Kong person” in Rule 5(2), we suggest clarifying paragraph (a) by replacing the word “individual” with the words “natural person”. We believe this reflects the intent of the drafting. If however we are wrong and paragraph (a) is meant to catch a wider group than natural persons, the drafting should be amended to clarify this.

Other than the above, we have no comments on the proposed definition of “Hong Kong person”, “RCH” or “ATS-CCP”.

Q2. Do you have any comments or concerns about the proposed types of IRS and NDF that will be subject to the mandatory reporting obligation in the initial phase of implementation?

Law Society's Response:

No comments.

Q3. Do you have any comments or concerns as to how IRS and NDF are proposed to be defined in Part 1 of Schedule 1 to the Draft Rules, or how the reportable transactions, or the class to which they belong, have been described in Part 3 of Schedule 1?

Law Society's Response:

No comments.

Q4. Do you have any comments or concerns about how the terms “conducted in Hong Kong” and “affiliate” are proposed to be construed, or how this limb of the reporting obligation is cast? In particular, do you have concerns as to how this proposal might impact entities that keep a global book?

Law Society’s Response:

Meaning of ‘performing functions substantially in Hong Kong’: We agree with the thrust of paragraph 66(d) that the relevant trader must be predominantly based in Hong Kong. The intention of paragraph 66(d) however is not reflected in Rule 4(b)(ii), which uses a lower threshold of the trader performing a ‘substantial part’ of his or her duties in Hong Kong. Although the determination of what is a ‘substantial part’ will involve both quantitative and qualitative judgment, it may be regarded as involving a threshold as low as 5%. A predominantly based threshold suggests a threshold of 50%.

We suggest amending Rule 4(b)(ii) to reflect paragraph 66(d).

Q5. Do you have any comments or concerns about how we have cast the proposal that AIs and LCs that are registered/licensed for Type 9 RA must report transactions that they have entered into in their capacity as fund managers?

Law Society’s Response:

It is unclear how to apply the provision that a Type 9 RA entity ‘enters into’ a transaction on behalf of another person. Asset management groups often delegate various functions to affiliates/third parties in other jurisdiction, including the actual entering into of investment contracts. For example, a Type 9 RA entity may, under its discretionary asset management mandate, decide that its client should enter into an investment contract. The Type 9 RA entity may then instruct its affiliate in, say, New York, to enter into the investment contract.

In this case, the Type 9 RA entity does not ‘enter into’ the investment contract on behalf of the client. The act of ‘entering into’ is carried out by the New York affiliate.

We expect the likely intention is that the Type 9 RA entity should report this transaction. The language in Rules 9(1)(c), 10(1)(c) and 11(1)(c) should therefore be clarified – likely by expanding the phrase ‘enters into’ to also include ‘procures the entering into of’ the relevant transaction.

We note that the key to the Type 9 RA is the making of discretionary asset management decisions. Fund managers may delegate discretionary asset management decisions to others (without retaining responsibility for those trades). From our reading of the rules, if a Type 9 RA entity delegates discretionary asset management decisions to, say, an overseas affiliate, then the trades effected by that overseas affiliate will fall outside the Rules 9(1)(c), 10(1)(c) and 11(1)(c) reporting regime because the Type 9 RA entity has neither ‘entered into’ nor (as discussed in the paragraph above) ‘procured the entering into of’ the relevant trades effected by the overseas affiliate. We regard this to be an appropriate position to take – certainly for the introduction of this new reporting regime.

As a clarification, we note that paragraph 71 suggests that the Type 9 RA in relation to an overseas incorporated AI is only applicable to activities carried out by its Hong Kong branch. There will also be potential non-Hong Kong activities caught by Rule 11(1)(d) – an example being overseas incorporated AIs who market to the Hong Kong public their services of managing segregated accounts. We regard it as appropriate to capture such activities within the reporting obligation.

Q6. Do you envisage any specific difficulties if this proposal were to be extended to also require an AI or LC that is registered/licensed for Type 9 RA to report transactions that it has advised a counterparty on, i.e. even though it has not entered into the transaction on behalf of that counterparty? If so, please provide details of the specific difficulties envisaged.

Law Society's Response:

Conceptually, this seems to confuse the different roles of advisory and discretionary management. It is unlikely that the contemplated advice would fall within the paragraph (iva) exemption to the definition of "advising on securities" and so may well require the relevant AI or LC to also hold a Type 4 RA.

We suggest that the anti-avoidance concern would be better dealt with in the SFC's Codes of Conduct.

Q7. Do you have any comments or concerns about how the reporting obligation in respect of CCPs has been cast?

Law Society's Response:

No comments.

Q8. Do you have any comments or concerns about the proposed approach to be taken in respect of the different types of Hong Kong persons?

Law Society's Response:

Our response to Q4 also applies to the words 'a substantial part of his or her duties' in Rule 11(1)(b)(ii)(B).

Is it correct that, as stated in paragraph 80, an NDF in a specified currency would not come within the reporting obligation of Hong Kong persons? Does this tally with Part 3 of Schedule 1?

Other than the above, we have no comments or concerns.

Q9. Do you have any comments or concerns about how the reporting obligation will

apply to funds? Do you envisage that funds may face practical difficulties in complying with this obligation? If so, please provide details of the specific difficulties envisaged.

Law Society's Response:

Although the point may largely be clarified by subsequent amendments pursuant to our comment to Q5, if there remain circumstances where a fund that is a Hong Kong person may not know whether its contractual asset manager (a Type 9 RA entity being a licensed corporation or authorized financial institution) is required to report a specified OTC derivative transaction that falls within the scope of the asset management contract, then the Type 9 RA asset manager entity should be obliged to notify the fund of each type of specified OTC derivative transaction (or each type of related transaction process) that the asset manager is not required to so report and which the fund is required to report.

Q10. Do you have any comments or concerns about the proposed methodology for calculating if the reporting threshold or exit threshold has been reached?

Law Society's Response:

No comments.

Q11. Do you have any comments or concerns about the proposed levels of the reporting threshold and exit threshold?

Law Society's Response:

No comments.

Q12. Do you have any comments or concerns about the proposed reductions to the reporting threshold and exit threshold at a later stage?

Law Society's Response:

No comments.

Q13. Do you have any comments or concerns about the proposed application of the mandatory reporting obligation to cross-border transactions? If so, please provide specific details.

Law Society's Response:

No comments.

Q14. Do you have any comments or concerns about the proposed exemptions and reliefs, and the criteria for triggering them?

Law Society's Response:

Exempt persons: We suggest including some flexibility to enable an exempt person to revive the exempt person relief in the event that, say, it has outstanding six transactions for a particular product class. We expect such revival would require the consent of the SFC.

As the Rules are currently drafted, a person may be an exempt person if it has, say, six outstanding class transactions having in aggregate a total gross notional value of US\$25million. In other words, Rule 3(2)(e) requires contravention of both the maximum number of transactions (being five) and the maximum gross notional value (being US\$30million).

We regard the way in which this Rule is currently drafted as being the correct approach, although the Rule does not tally with the description in paragraphs 100(b) and 100(c) which regard these two limbs as separate. Perhaps the point can be highlighted in the consultation conclusions to avoid misinterpretation by readers.

Hong Kong persons: We suggest changing the Draft Rules so that a Hong Kong person need not report a reportable transaction if it enters into the transaction with a locally incorporated AI, an AMB or a LC. In other words, the obligation that the transaction is 'also subject to reporting' is removed in respect of these counterparties.

The 'also subject to reporting' limb would be retained for all other cases as drafted.

The reason for the change is to make it simpler for Hong Kong persons to be confident that an exemption applies, without them needing to be concerned with the reporting rules applicable to locally incorporated AIs, AMBs and LCs.

We do not regard the above suggestion as changing the commercial intention of the exemption. Its purpose is merely to simplify the exemption.

We feel less strongly about simplifying the exemption in the context of fund management, given the strong connections between funds and their managers.

Q15. Do you have any comments or concerns about the proposal to exclude from the exempt person relief for IRS and NDF those licensed banks which have already reported to the HKMA via the HKTR under the interim reporting requirement and have outstanding reportable transactions on the commencement of the Draft Rules?

Law Society's Response:

No comments.

Q16. With respect to the relief for AIs, AMBs and LCs that are less active in the OTC derivatives market, do you consider the proposed criteria of 5 transactions per product class, and aggregate gross notional value of US\$30 million to be appropriate? If not, please provide specific details of why they may be inappropriate and what alternative criteria should be adopted.

Law Society's Response:

We have no particular view on the level of thresholds. We refer to our comment to Q14 on whether both thresholds need to be met (which we regard to be the better position) and on reviving the relief in certain circumstances.

Q17. Do you have any comments or concerns about how the proposed backloading requirement will apply to transactions outstanding on the starting day? If so, please provide specific details.

Law Society's Response:

No comments.

Q18. Do you have any comments or concerns about the proposal to have different starting days in respect of different types of reportable transactions? If so, please provide specific details.

Law Society's Response:

No comments.

Q19. Do you have any comments or concerns about how the starting day might impact AIs, AMBs and LCs that previously qualified for the exempt person relief? If so, please provide specific details.

Law Society's Response:

No comments. We refer to our comment to Q14 about reviving the relief in certain circumstances.

Q20. Do you have any comments or concerns about how the concession period and grace period are proposed to operate?

Law Society's Response:

Please see our comment to Q21 below.

Q21. Do you have any comments or concerns about how the grace periods will vary in respect of entities that become an AI, AMB or LC at a later date, or that cease to be an exempt person at a later date?

Law Society's Response:

We suggest including a renewed concession period for an entity ceasing to be an exempt person. Such cessation may occur inadvertently and so the reporting channel may not be in place as at the date of cessation. This situation should not be treated in the same way as attaining regulated status (as the attainment of regulated status will not happen inadvertently).

Q22. Do you have any comments or concerns about the proposed types of transaction information required to be reported for the purposes of the reporting obligation, or as to how these have been expressed in Schedule 2?

Law Society's Response:

We suggest clarifying how to report equal and opposite transactions which have the commercial effect of closing out (either fully or partially) an existing transaction. No doubt this point has been resolved satisfactorily under the HKMA's interim reporting requirements. Such position should be followed here.

Q23. Do you have any comments or concerns about the proposal to require the reporting of valuation transaction information in the future?

Law Society's Response:

The definition of "subsequent event" is broad and vague. For example, is it intended to cover sub-participations, where the parties remain the same? A list of specific events should be included instead, which may include assignments, novations, transfers, amendments, permanent waivers. A list of events that are not 'subsequent events' should also be included, such as termination. The lists should clarify the position of sub-participations.

Q24. Do you have any comments or concerns about our proposals on how subsequent events are to be reported, and when they will cease to be reportable?

Law Society's Response:

No comments.

Q25. Do you have any comments or concerns about the proposals on masking counterparty information under certain circumstances as a temporary measure?

Law Society's Response:

No comments.

Q26. Do you have any comments or concerns about the proposals for subsequently reporting information when the pre-requisites for masking cease to exist?

Law Society's Response:

No comments.

Q27. Do you have any comments or concerns about the proposal that an AI's reporting obligations in respect of transactions entered into by its specified subsidiaries should be the same as its reporting obligations in respect of transactions to which it is a counterparty itself?

Law Society's Response:

No comments.

Q28. Do you have any comments or concerns about the proposed record keeping requirements in relation to mandatory reporting?

Law Society's Response:

No comments.

Q29. Do you have any comments or concerns about the types of records proposed to be kept, and the manner in which they are to be kept?

Law Society's Response:

No comments.

Q30. Do you have any comments or concerns about the duration for which the records are proposed to be kept?

Law Society's Response:

No comments.

**The Law Society of Hong Kong
2 September 2014**